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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MARC SPITZER, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
MIKE GLEASON
KRISTIN K. MAYES

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AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY FOR A
HEARING TO DETERMINE THE FAIR VALUE
OF THE UTILITY PROPERTY OF THE
COMPANY FOR RATEMAKING PURPOSES, TO
FIX A JUST AND REASONABLE RATE OF
RETURN TEHREON, TO APROVE RATE
SCHEDULES DESIGNED TO DEVELOP SUCH
RETURN, AND FOR APPROVAL OF
PURCHASED POWER CONTRACT.

Docket No. E-01345A-03-0437

NOTICE OF FILING

Staff hereby provides notice of filing the Addendum to the Direct Testimony of Linda A. Jaress. This addendum is submitted in response to the questions contained in Commissioner Mike Gleason's September 5, 2003 letter to the parties in this docket.

RESPECTFULLY SUBMITTED this 23rd day of February, 2004.

Arizona Corporation Commission

DOCKETED

FEB 23 2004

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ADDENDUM TO

DIRECT

TESTIMONY

OF

LINDA A. JARESS

DOCKET NO. E-01345A-03-0437

**ARIZONA PUBLIC SERVICE COMPANY FOR
A HEARING TO DETERMINE THE FAIR VALUE
OF THE UTILITY PROPERTY OF THE COMPANY
FOR RATEMAKING PURPOSES, TO FIX A JUST
AND REASONABLE RATE OF RETURN
THEREON, TO APPROVE RATE SCHEDULES
DESIGNED TO DEVELOP SUCH RETURN, AND
FOR APPROVAL OF PURCHASED POWER
CONTRACT**

FEBRUARY 23, 2004

BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER
Chairman
WILLIAM A. MUNDELL
Commissioner
JEFF HATCH-MILLER
Commissioner
MIKE GLEASON
Commissioner
KRISTIN K. MAYES
Commissioner

IN THE MATTER OF THE APPLICATION OF)	DOCKET NO. E-01345A-03-0437
ARIZONA PUBLIC SERVICE COMPANY FOR)	
A HEARING TO DETERMINE THE FAIR VALUE)	
OF THE UTILITY PROPERTY OF THE COMPANY)	
FOR RATEMAKING PURPOSES, TO FIX A JUST)	
AND REASONABLE RATE OF RETURN)	
THEREON, TO APPROVE RATE SCHEDULES)	
DESIGNED TO DEVELOP SUCH RETURN, AND)	
FOR APPROVAL OF PURCHASED POWER)	
<u>CONTRACT</u>)	

ADDENDUM TO THE DIRECT
TESTIMONY
OF
LINDA A. JARESS
EXECUTIVE CONSULTANT III
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

FEBRUARY 23, 2002

1 **Q. Please state your name, occupation, and business address.**

2 A. My name is Linda A. Jaress. I am an Executive Consultant III in the Utilities Division of
3 the Arizona Corporation Commission ("Commission"). My business address is 1200
4 West Washington Street, Phoenix, Arizona 85007.

5
6 **Q. Did you file direct testimony in this docket on February 3, 2004?**

7 A. Yes, I did.
8

9 **Q. What is the purpose of this addendum to your testimony?**

10 A. The purpose of this addendum to my testimony is to provide Staff's response to the
11 questions raised by Commissioner Gleason in his letter to the parties to this case, as filed
12 on September 8, 2003.
13

14 **Q. What are Commissioner Gleason's first two questions?**

15 A. The first is, "How should the Commission calculate the market value of a power plant?"
16 and the second, "If the Commission should look at the plant's current market value instead
17 of the original cost to build the plant, how can the Commission determine the market
18 value?" These questions are closely related in that both address the determination of
19 market value of power plants. Thus, I will respond to both simultaneously.
20

21 Establishing power plant values, or the value (price) of any asset, typically requires
22 application of one of two methods. One method is the discounted cash flow ("DCF")
23 method. Under the DCF method, future cash flows associated with the projected revenues
24 from the sale of power, less expenses, are discounted by applying a discount rate to create
25 a present value, or price. In other words, the value of the plant today is equal to the
26 present value of its future cash flows. The inputs to the estimates of the future cash flows

1 and the applied discount rate typically reflect a vast range of assumptions that can
2 significantly affect the outcome of the analysis.

3
4 A second means of calculating the market value of a power plant is through a review of
5 actual sales transactions involving similar generating assets. The sales prices of
6 "comparable" plants sold in "comparable" markets establish primary reference points.
7 Close attention must be paid to the particulars of the power plants, markets, financing, etc.
8 to ensure comparability and, hence, a reasonable market valuation. This method is limited
9 by the number and comparability of recent sales. In seeking to determine the market value
10 of a power plant, a commission could rely on the results of a DCF analysis, a comparables
11 analysis, or a combination of the two.

12
13 **Q. Has Staff made a recommendation in this case as to the market value of the PWEC**
14 **assets?**

15 A. No.

16
17 **Q. Why hasn't Staff addressed the market value of the PWEC assets in its analysis of**
18 **whether the PWEC assets should be rate based?**

19 A. Staff's focus has been on whether the Company has demonstrated that the PWEC assets
20 would be an appropriate addition to APS' supply portfolio and ratebase at the value
21 proposed. The Company has proposed to ratebase the PWEC assets at net book value
22 rather than at market value.

23
24 **Q. What is Commissioner Gleason's third question?**

25 A. Commissioner Gleason's third question is, "What power plants are on the market that can
26 serve Arizona consumers?"
27

1 **Q. Is Staff aware of power plants that can serve Arizona that are for sale?**

2 A. Staff is aware that there are power plants in Arizona that are financially distressed and
3 may be for sale. On February 5, 2004, TECO Energy, Inc. announced its decision to exit
4 from its ownership of its Gila River plant and announced a letter of intent with certain
5 lenders to transfer ownership of the plant to them. Also, National Energy & Gas
6 Transmission (previously, PG & E National Energy Group) has reached an agreement
7 with lenders to transfer their Arizona plant, Harquahala Generating, to the lenders.
8 However, a potential purchaser in the market for a power plant, such as APS, would have
9 more generator-specific information regarding this market than Staff.

10
11 I note that, before the results of the December 2003 RFP are used as an indicator of the
12 market value of other generating units that could serve the Arizona market, the Company
13 should demonstrate that (1) its solicitation was properly-designed and implemented, and
14 (2) the results of the December 2003 solicitation are in fact fully comparable and
15 appropriate to the proposed application.

16
17 **Q. Regarding the Commissioner's fourth question, what actions has Staff taken to**
18 **respond?**

19 A. Commissioner Gleason's letter also asks, "Has any other state commission faced a
20 situation where a regulated energy utility applied to incorporate merchant assets into its
21 rate base? What did that commission decide?" Staff contacted 41 state public utilities
22 commissions and received responses from 38. Staff also spoke with a FERC
23 representative regarding potential FERC matters relevant to this question.

24
25 According to Staff of the Washington Utilities and Transportation Commission, Avista
26 Utilities acquired the Coyote Springs II generating plant from an affiliate and, through a
27 settlement agreement approved by the Commission, was allowed to include the plant in

1 rate base. However, neither the settlement agreement nor the Decision that approved the
2 settlement agreement discusses the matter of valuation.

3
4 NorthWestern Energy, the current owner of the distribution assets of the now defunct
5 Montana Power Company, is currently before the Montana Commission requesting
6 approval of a 10-year contract with an affiliate which owns the Montana First Megawatts
7 generating plant under construction in Great Falls, Montana. According to a Montana
8 Commission Staff member, discussions are also being held about rate-basing the plant.

9
10 In another case somewhat related to the Commissioner's question, is currently underway
11 at the California Public Utilities Commission regarding an application by Southern
12 California Edison for approval to acquire, develop, construct, own and operate
13 Mountainview Power Project as a wholly-owned subsidiary and to enter a power purchase
14 agreement with the subsidiary for the purchase of electricity. One of the proposals under
15 consideration is for the utility to directly own the plant and include it in rate base rather
16 than enter a purchased power contract with the subsidiary which would own the plant.

17
18 Also, in a similar case, Duquesne Light Company filed an application with the
19 Pennsylvania Public Utilities Commission in December 2003, for approval of a "Plan for
20 Provider of Last Resort." The Plan includes a power contract with a direct subsidiary
21 which has recently entered into an agreement to purchase the Sunbury Station generating
22 plant in Shamokin Dam, Pennsylvania. The application is currently under review.

1 **Q. The fifth question is, "How will competitive solicitation of wholesale power as**
2 **envisioned in the Commission's Track B Order be affected by the inclusion of PWEC**
3 **assets into APS?" Please respond.**

4 A. Under the power contract between APS and PWEC that was part of the outcome of the
5 competitive solicitation process, APS is purchasing 1,700 MW of capacity in the summer
6 months from PWEC. APS has asserted that, if the PWEC assets are ratebased, the
7 contract will be ended. The most apparent impact, of ratebasing the PWEC assets would
8 be felt in September 2006, when the contract's term would have ordinarily expired. At
9 that point, at least 1,700 MW of capacity will not need to be competitively bid. Thus, the
10 Arizona market available to other suppliers will be diminished, which could affect them
11 economically and could affect the long term viability of some.

12
13 Also, and most importantly, ratebasing the PWEC assets anytime before the expiration of
14 the APS/PWEC contract would cause APS customers to lose some of the \$200 million of
15 the benefits of the Track B solicitation already undertaken.

16
17 **Q. Does this conclude the addendum to your testimony?**

18 A. Yes, it does.